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In the Supreme Court of the United States

OCTOBER TERM, 1995

ROBERT W. SCARTH, ET AL., PETITIONERS

v.

NICOR EXPLORATION COMPANY, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals correctly set aside an order of the Federal Energy Regulatory Commission that interpreted clauses specifying statutorily regulated rates for the wellhead sale of natural gas.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 50 F.3d 1341. The orders of the Federal Energy Regulatory Commission are reported at 58 F.E.R.C. ¶ 61,203 (affirming administrative law judge) (Pet. App. 32a-53a); 63 F.E.R.C. ¶ 61,034 (granting rehearing in part) (Pet. App. 54a-75a), and 66 F.E.R.C. ¶ 61,276 (denying rehearing) (Pet. App. 76a-99a). The initial decision of the administrative law judge (Pet. App. 15a-31a) is reported at 56 F.E.R.C. ¶ 63,023.

JURISDICTION

The judgment of the court of appeals was entered on April 27, 1995. A petition for rehearing was denied on July 5, 1995. Pet. App. 100a. The petition for a writ of certiorari was filed on October 3, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This case concerns implementation of the federal statutory schemes that formerly governed natural gas rates and were administered by the Federal Energy Regulatory Commission (FERC or the Commission) and its predecessor, the Federal Power Commission (FPC).[1] The underlying dispute focused on whether certain clauses in contracts drafted in 1970 for the sale of natural gas authorized petitioners to charge respondent NICOR Exploration Company (NICOR) incentive-based rates pursuant to Section 108 of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. 3318 (1988), or whether those clauses restricted petitioners to the "just and reasonable" cost-based rates prescribed by the FPC under the Natural Gas Act (NGA), 15 U.S.C. 717 *et seq.*, that prevailed when the contract was made.[2] An administrative law judge concluded that the clauses did not authorize the new, higher rates. After initially affirming the adminis-

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[1] FERC assumed the FPC's functions and responsibilities on October 1, 1977. Department of Energy Organization Act § 402(a), 42 U.S.C. 7172(a); Exec. Order No. 12,009, 3 C.F.R. 142 (1978); 42 Fed. Reg. 46,267 (1977).

[2] As a result of the Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 Stat. 157, FERC no longer has jurisdiction over natural gas rates.

trative law judge, the Commission reconsidered and reversed its earlier order and determined that the contracts allowed such rates. The court of appeals vacated the Commission's order on the ground that the Commission had not properly applied Oklahoma state law in interpreting the contract clause, thereby giving inadequate consideration to extrinsic evidence of the contracting parties' intent to allow future rate increases, and improperly shifting the burden of proof from petitioners to NICOR regarding that intent.

1. a. The rate-clause interpretation issue in this case arises from the change in the statutory scheme governing natural gas rates effected by the enactment of the NGPA, 15 U.S.C. 3301 *et seq.*, which adopted rate-setting methodologies that differed in some respects from those established in the NGA, 15 U.S.C. 717 *et seq.* Before 1978, the FPC acted under the NGA to establish "just and reasonable" wellhead rates for the sale of natural gas based on a producer's costs. During the gas shortages of the 1970s, gas supply contracts typically contained "area rate clauses," a type of price escalator clause that automatically raised the cost-based contractual price to the maximum "just and reasonable" ceiling rate authorized by the Commission in rate proceedings for a particular geographic area. See *Pennzoil Co.* v. *FERC* (*Pennzoil I*), 645 F.2d 360, 366-367 (5th Cir. 1981), cert. denied, 454 U.S. 1142 (1982); Order 329, 36 F.P.C. 925 (1966).

Congress's enactment of the NGPA in 1978 altered the existing scheme governing rates for wellhead sales of natural gas. The NGPA substituted statutorily set rates for rates prescribed by FERC. Pet. App. 3a; *Pennzoil Co.* v. *FERC* (*Pennzoil II*), 789 F.2d 1128, 1132 (5th Cir. 1986). While Section 104 of

the NGPA, 15 U.S.C. 3314 (1988), generally continued the earlier, cost-based methodology for setting rates for certain categories of natural gas, Section 108 allowed significantly higher, incentive-based rates for gas produced from "stripper wells." See Pet. App. 3a.[3]

b. In a set of orders collectively referred to as Order 23, the Commission determined that neither the NGPA nor its own regulations precluded producer-sellers whose contracts contained pre-NGPA area rate clauses from obtaining higher NGPA incentive rates. Order 23, 6 F.E.R.C. ¶ 61,229 (1979); Order 23-A, 7 F.E.R.C. ¶ 61,247 (1979); Order 23-B, 8 F.E.R.C. ¶ 61,130 (1979); see *Pennzoil II*, 789 F.2d at 1132; Pet. App. 4a. Rather than construing all such rate clauses uniformly, however, the Commission adopted a case-by-case approach, applying general principles of contract law. Pet. App. 4a. On review of Order 23, the Fifth Circuit affirmed in large part, but held that "specific determinations of contractual authority in the protest procedures must take account of and follow any differences with general contract law that the appropriate state contract law may have." *Pennzoil I*, 645 F.2d at 383-384. The court also noted that "the burden of proof [to show entitlement to the higher rates] is entirely on the seller since he is the party seeking the rate increase." *Id.* at 370.

c. In its first opinion resolving a specific controversy over an area rate clause, the Commission

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[3] A "stripper well" produces not more than an average of 60 Mcf (thousand cubic feet) per day. Other than deregulated gas, this category receives the most favorable pricing treatment under the NGPA. *Pennzoil I*, 645 F.2d at 370 n.16 (citing Section 108 of the NGPA).

developed a two-step test for determining the contracting parties' mutual intent under Order 23. *Independent Oil & Gas Ass'n of West Virginia*, 10 F.E.R.C. ¶ 61,214 (1980) (Opinion 77), petitions for review dismissed without prejudice, *Pennzoil Co.* v. *FERC*, 645 F.2d 394 (5th Cir. 1981). The Commission's first step was to consider extrinsic evidence proffered by the parties regarding intent. Where the extrinsic evidence was inconclusive or unreliable, the Commission proceeded to the second step to examine the language of the area rate clause for specific features that would show an intent *not* to authorize incentive-based rates when such rates became available, as they did under Section 108 of the NGPA. The Commission identified three such features: (1) a reference to administratively prescribed or established rates; (2) the linking of such a reference to administrative action with a reference to either the NGA generally, or the NGA's "just and reasonable" standard specifically; and (3) an absence of additional language uncoupling that link. In the Commission's view, the presence of both (1) and (2)—*i.e.*, references to both administrative rate setting and the NGA—generally would indicate that the parties intended to authorize only cost-based rates, except where the clause affirmatively suggests that relevant administrative action need not be linked to the NGA price structure.

2. The contracts at issue in this case involved gas produced from an Oklahoma well. The contracts were executed in 1970 by NICOR, the purchaser of the gas, and the GHK Company, Sun Oil Company and Amerada Hess Corporation, the producer-sellers. Each contract contained a substantially similar area rate

clause.[4] Between 1988 and 1989, petitioners acquired the producers' interests in all three contracts and attempted to collect higher, incentive-based rates under Section 108 of the NGPA. NICOR contested the rate increases. Pet. App. 2a.

a. Following an evidentiary hearing, an administrative law judge (ALJ) ruled that the three contracts did not authorize the higher Section 108 rates. Pet. App. 15a-31a. The ALJ concluded that the extrinsic evidence did not support petitioners' contention that the parties intended the clauses to authorize the maximum rate increases allowed by law, and that the clauses' language satisfied the three criteria of Opinion 77, thus requiring the continued application of cost-based rates. *Id.* at 20a-21a.

After initially affirming the ALJ's decision, Pet. App. 32a-53a, the Commission granted rehearing and reversed, concluding that the contracts allowed petitioners to charge the incentive-based rates of Section 108 of the NGPA, *id.* at 54a-75a. The Commission

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[4] The area rate clauses of the Sun and GHK contracts read as follows:

> If the Federal Power Commission, or any successor governmental authority having jurisdiction in the premises, shall at any time hereafter prescribe, for the area in which the contract is located, a higher, applicable, just and reasonable area rate for the purchase of gas than the price herein provided to be paid, then the price to be paid by the Buyer to Seller for gas delivered under the provisions of this Agreement shall be increased to equal such higher price effective as of the date such higher price is made applicable to the gas sold hereunder.

Pet. App. 2a-3a. Other than its omission of the phrase "just and reasonable," the Amerada Hess area rate clause was identical to the other two. *Id.* at 3a n.1.

agreed with the ALJ that extrinsic evidence failed to establish the parties' mutual intent to authorize the maximum legal rate increases. *Id.* at 57a-69a. Unlike the ALJ, however, the Commission concluded that the area rate clauses allowed Section 108 rates because each clause failed to satisfy one or more elements of Opinion 77's three-part test. *Id.* at 57a, 69a-75a.

b. The court of appeals vacated the Commission's order for failure correctly to apply Oklahoma law. Pet. App. 1a-14a.[5] The court acknowledged that in *Pennzoil I* it had affirmed the Commission's decision to formulate and apply general principles of contract law in construing area rate clauses, but noted that it had also required the Commission to "take account of and follow any differences with general contract law that the appropriate state contract law may have." *Id.* at 8a-9a (quoting *Pennzoil I*, 645 F.2d at 383-384). The court determined that no deference was due to the Commission's application of Oklahoma law to interpret the gas supply contracts at issue here, because the Commission had not used its factual or technical expertise. Pet. App. 10a. The court thus reviewed the Commission's order de novo. *Ibid.*

The court determined that Oklahoma law, as well as its own prior opinion in *Hunt Oil Co.* v. *FERC*, 853 F.2d 1226, 1237 (5th Cir. 1988), required the Commission to consider extrinsic evidence of intent in construing the area rate clauses. The court found FERC's approach "defective" because the Commission failed to consider the extrinsic evidence further after having found it inconclusive of the parties'

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[5] The court held that Oklahoma law governed this proceeding because Oklahoma had had extensive contacts with the three contracts. Pet. App. 9a-10a.

intent. Even inconclusive extrinsic evidence, in the court's view, must be balanced with the indications in the text of the area rate clauses themselves to determine the parties' intent. Pet. App. 11a-12a. The Commission's approach was also inconsistent with Oklahoma law, the court concluded, because it "narrowly focuse[d] on specific phrases in the area rate clauses without considering the language of the clauses and contracts as a whole." *Id.* at 12a.

The court also determined that the Commission's approach "conflict[ed] with th[e] court's holding in *Pennzoil I* that the producer bears the burden of proving that an area rate clause authorizes incentive-based rates under the NGPA." Pet. App. 13a (citing *Pennzoil I*, 645 F.2d at 370). To the extent that Opinion 77's three-prong approach to analyzing the language of area rate clauses required NICOR to prove the *absence* of contractual authority for the higher, incentive-based rates, the court held that it impermissibly relieved petitioners of the burden of proof of authorization for the higher rates that they would have borne under Oklahoma law. Pet. App. 12a-13a.

ARGUMENT

1. The question whether courts must defer to FERC's interpretation of area rate clauses such as those at issue in this case is no longer significant, because, as a result of the Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 Stat. 157, FERC's jurisdiction over producer rates ended on January 1, 1993. As petitioners noted in their brief in the court of appeals (Pet. C.A. Br. 2 n.1), this may be the last of the "area rate clause" cases. Thus, although the Fifth Circuit's failure to afford defer-

ence to FERC's interpretation of the area rate clauses appears to be in tension with the approach of other courts of appeals with respect to FERC's interpretation of contracts in other settings, see, *e.g.*, *National Fuel Gas Supply Corp.* v. *FERC*, 811 F.2d 1563, 1568-1573 (D.C. Cir.) (FERC interpretation of FERC-approved settlement agreement), cert. denied, 484 U.S. 869 (1987),[6] review of that issue is best left to a case of lasting significance, rather than one tied to the interpretation of contracts under a statutory scheme that is no longer in place.[7] Moreover, if the

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[6] *National Fuel*, 811 F.2d at 1569-1570, required deference on even "'pure' questions of law" regarding contract interpretation. Even under that standard, however, it is unclear whether the court of appeals would have reached a different conclusion in this case. If the court of appeals was correct that FERC shifted the burden of proof and employed canons of construction at odds with Oklahoma law, such errors likely would not have survived even the deferential review called for by *National Fuel*.

[7] In any event, none of the cases that petitioners cite (Pet. 9-12) actually conflicts with the decision below. Although the courts properly deferred to FERC, they did so in cases that did not involve area rate clauses, and that did not raise any question whether FERC's application of state-law canons of construction or its allocation of the burden of proof warrants deference. For example, in *Northwest Pipeline Corp.* v. *FERC*, 61 F.3d 1479, 1487 (10th Cir. 1995), the court did not reach the question whether FERC was entitled to deference with regard to canons of contract law because it determined that the Commission correctly applied the same canons of construction as would a reviewing court. *Williams Natural Gas Co.* v. *FERC*, 3 F.3d 1544, 1549 (D.C. Cir. 1993), addressed only the deference due FERC's construction of contract terms, and not the question whether legal canons of construction were properly applied. The court in *Consolidated Gas Supply Corp.*

issue should arise in other circumstances in the Fifth Circuit in the future, that court may conclude that the particular context warrants greater deference to FERC's interpretation or may reconsider and reconcile its general approach with the prevailing view under *Chevron U.S.A. Inc.* v. *Natural Resources Defense Counsel, Inc.*, 467 U.S. 837 (1984), without the intervention of this Court.

2. Petitioners' remaining contentions (Pet. Br. 13-30) likewise afford no basis for further review. Petitioners assert that the court of appeals failed to follow the substantial evidence standard for reviewing agency fact-findings, misinterpreted Oklahoma law, and usurped FERC's discretion by directing entry of an order in favor of NICOR rather than remanding the case for further proceedings. Those issues are factbound. Petitioners do not contend that the court announced a general rule regarding substantial evidence, but merely that the court failed to apply that principle here. To the extent that a misapplication of the general principle was involved, it cannot be expected to have ramifications beyond this case. The correct application of Oklahoma law to the facts of this case is similarly not a question of broad importance. Finally, although courts normally must remand when they set aside agency decisions, see *FPC* v. *Idaho Power Co.*, 344 U.S. 17, 20 (1952), the failure to do so here lacks practical significance, because the court's decision left FERC no option beyond requiring petitioners to rescind the unauthorized rates.

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v. *FERC*, 745 F.2d 281, 291 (4th Cir. 1984), agreed with FERC's interpretation of the terms of a settlement agreement.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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